although not entirely) forward-looking cost-based rates for transport facilities. It is impossible to specify the "costs" associated with TIC revenues. To do so would require the following exercise:

- first, the Commission would have to determine that all access rates ideally should be based on embedded costs;
- second, the Commission would have to undertake a comprehensive examination of the "correct" method of allocating such embedded costs among rate elements -- and in particular, to revisit all the detailed decisions in the Transport Rate Structure and Pricing proceeding; and
- third, the Commission would have to calculate the difference between existing rate levels and the way embedded costs allocated to the interstate jurisdiction were allocated in 1990, prior to the inception of price cap regulation. This difference would determine the "proper" level of rates for other services, and would dictate how TIC "costs" should be "re-allocated."

This intellectual exercise would not only be counterproductive, it would be contrary to the Commission's stated policy objective of moving rate levels toward forward-looking costs and of moving away from rate-of-return regulation based on embedded costs. Indeed, the notion is precluded by the very logic behind price cap regulation, which the incumbent LECs have vigorously supported. Accordingly, the Commission should take no action on the incumbent LEC suggestions on which it seeks comment in paragraphs 102, 104-06, and 109-110 of the Notice.

WorldCom also opposes the incumbent LEC theory, discussed in paragraphs 250-55 and 266-70 of the Notice, that inadequate depreciation in the past creates a present entitlement to a revenue stream insulated from competitive pressure. First, we believe that depreciation has been more than adequate in the past to recover incumbent LECs' investments, and that any reserve deficiency is relatively small. 74/ Second, even before the advent of competition in the telecommunications marketplace, under rate of return regulation incumbent LECs bore the risk of declines in the replacement value of equipment investments due to technological advances. Third, for price cap LECs, absent sharing, depreciation rates have been irrelevant to rate levels since the inception of price cap regulation, and no exogenous adjustments have been allowed to reflect depreciation changes due to the control that the LECs exercise over such costs. Indeed, incumbent LECs had ample opportunities in the past to affect their depreciation rates, and have always had complete control over their equipment purchasing decisions; they should not be held harmless from unfortunate decisions to invest in equipment that subsequently lost value due to technological changes. Finally, and most significantly, in the newly competitive marketplace, there is no basis for guaranteeing the past or present investments of any class of carriers. Any such guarantee would fundamentally skew competition.

Rather than attempting to ascertain which "costs" are recovered through the TIC, the Commission should undertake a number of modest, prescriptive price level changes that would reduce the level of the TIC within a

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74/ See Notice, ¶ 252 (citing MCI study).

short time frame. For all of the recommendations that follow, we submit that all rate adjustments should be focused on the TIC, even if arguably some reductions might logically flow to the switching, special access, or transport (facilities) rate elements. These other elements are now, or would be after the modest prescriptive changes we recommend in the discussion above, more or less cost based, whereas the TIC is completely unrelated to any costs, and therefore it makes sense to focus all these rate reductions on the TIC rather than other access rate elements.

First, remove universal service revenues from the TIC before allowing them to be taken from any other element of access charges. The implementation of a truly competitively-neutral universal service support mechanism pursuant to Section 254 should reduce the overall level of access charges. But there is no necessary connection between the universal service-induced access rate change and any particular access charge rate element. WorldCom submits that all universal service revenue changes that affect access charges should be taken first from the TIC, the most problematic and most obviously non-cost-based access charge. 75/

75/ This should be qualified in one minor respect. The CCL charge currently recovers an explicit universal service support component: the recovery of Long-Term Support ("LTS") revenues. When, pursuant to the Joint Board's recommendation, that revenue component is shifted from access charges to the competitively neutral universal service support mechanism, the revenue change should be reflected through reductions in the CCL charge. Universal Service Recommended Decision, ¶¶ 767-68.

Second, reflect all price cap rate reductions in the TIC. All overall access charge rate reductions due to the price cap system -- both the productivity adjustment and the consumer productivity dividend, as well as any further reductions resulting from a decision on the issues raised in the Fourth Further Notice of Proposed Rulemaking in the LEC Price Cap Performance Review proceeding 76/ -- should be reflected in focused reductions to the TIC. The TIC is the element of access charges that most seriously damages consumers and competition, so price cap benefits should be flowed first into the TIC. This requirement should be retained until the TIC is eliminated.

Third, reduce the TIC to reflect certain clear cost misallocations that obviously increase the TIC and other access charges. In particular, make the following changes:

- Eliminate the costs of SS7 common channel signaling, LIDB, and other related signaling services that may be reflected in the TIC or other access charges. 77/
- Eliminate the costs of the equal access network reconfiguration, which was completed in 1993, and take all access rate reductions first from the TIC. In 1986, the incumbent LECs increased their access charges to reflect this 8-year cost amortization, and they were to have reduced their access charges in 1993 upon the end of that amortization period, but they never did so. The disposition of these revenues from 1993 through the present must be resolved in pending annual access tariff investigation proceedings. But as a forward-looking matter, in this proceeding, the Commission should

76/ See infra Section III. C.

77/ See supra Section II.D.; Notice, ¶ 103.

ensure that the incumbent LECs not be allowed to continue this recovery of amortized costs, and that the exogenous cost adjustment needed to implement this change be reflected through a reduction in the TIC. 78/

- Identifiable separations problems should be addressed by shifting revenues from the TIC to interstate subscriber loop charges, pending separations reform. In particular, the Part 36 jurisdictional separations rules allocate some end user marketing and billing costs to the interstate jurisdiction. While ultimately all of these costs should be allocated to the intrastate jurisdiction, pending such a change, they should be recovered through a charge to end user subscribers -- the SLC (or, as a second-best solution, the flat-rate CCL charge that carriers may flow through to end users).

- The costs of non-regulated services now recovered through access charges should be removed from the TIC. In particular, some general support facilities ("GSF") investment associated with general purpose computers used for billing and collection is allocated to interstate access services, even through billing and collection is a non-regulated service. The Commission should correct the Part 32 (uniform system of accounts for regulated costs) and Part 64 (allocation of regulated and non-regulated costs) rules to remove this investment from access charges, and should require corresponding reductions in the TIC.

78/ Notice, ¶¶ 291-93. The Notice seeks comment on "whether it would be fair to require exogenous cost decreases to account for the completion of the amortization of equal access network reconfiguration costs in light of the fact that the Commission did not permit exogenous cost increases for equal access network reconfiguration costs." ¶ 293. The answer is simple: price cap regulation did not exist when the amortization was initiated. The Commission's conclusion that price cap carriers should not be permitted exogenous treatment of costs similar to the equal access network upgrade in the future was reasonable, and we support it. Price Cap Performance Review for Local Exchange Carriers, First Report and Order, 10 FCC Rcd 8961, 9089-9100, ¶¶ 292-304, 306-320 (1995). But it is by no means inconsistent with this conclusion for the Commission to direct that, to the extent that it allowed carriers to recover such costs through an explicit amortization in the past, before the inception of price caps, the costs must now be removed through an exogenous rate adjustment.

Finally, to the extent that any TIC remains after the reductions recommended above, the Commission should permit incumbent LECs to shift revenues from the TIC to the rates for transport and special access services in low-volume, high-cost areas. To the extent that average special access rates were too low a basis for transport rates in 1992, as alleged by USTA and other incumbent LECs, 79/ then the initial TIC would have been inflated. Such a change can be effected by reducing the upper band for the TIC service category and, at the same time, increasing the upper band for the Zone 3 (rural) special access and transport services. This rate change should be implemented through a short (one- to three-year) transition schedule, until the TIC is eliminated.

III. TRANSITION TOWARD MORE COMPETITIVE RATE LEVELS.

[Notice, Sections IV, V, and VI]

A. Overview: The Commission Should Use a Combination of "Carrots" and "Sticks" to Induce the Incumbent LECs to Facilitate Local Competition.

WorldCom believes that a market-based approach to access regulation is the best avenue to produce cost-based access rates, as well as a more competitive environment that eventually can eliminate the need for such regulation. In the short term, as discussed above, the Commission should implement rate structure changes that make access charges better reflect the way costs are incurred, and that

79/ Notice, ¶ 107.

create stronger competitive pressures on the incumbent LECs (i.e., shift revenue recovery from terminating traffic to originating traffic, and from traffic sensitive access charges to charges paid on a per-line basis). The baseline rate structure and rate level changes we recommend are critical prerequisites for such a market-based approach to work, and should be implemented as rapidly as possible. The Commission need not resolve in advance exactly what steps it will take after the baseline rate structure and rate level changes have been implemented; those changes are the highest priority and should be undertaken right away, with other steps possibly following after.

In the slightly longer term, the Commission should offer the incumbent LECs both "carrots" and "sticks" to induce comprehensive compliance with the full competitive checklist preconditions of Sections 251 and 252 -- especially unbundled network elements offered at forward-looking cost in a manner that enables competitors to package elements together to offer their own local services. The "carrot" to induce such compliance is the promise of future pricing flexibility. Once the preconditions to potential competition are met, the incumbent LECs should be allowed to engage in a number of measures of pricing flexibility -- but not measures that would enable them to discriminate and to avoid lowering access charges across the board.

The Commission should also use the access reform proceeding to brandish a "stick" to help induce the incumbent LECs to comply with the necessary prerequisites to local competition. The "stick" is the threat of prescriptive rate changes. If an incumbent LEC has not fully satisfied the checklist preconditions by January 1, 1999, then the Commission should credibly prescribe access rates based on a measure of forward-looking costs such as TSLRIC or TELRIC. If those local competition preconditions are not met, then the Commission can have no expectation that market forces will develop to discipline the level of access charges. Instead, the Commission will have to resort to prescribing the levels of all access rates based on forward-looking economic costs.

B. The "Carrot": Promise of Pricing Flexibility.

[Notice, Sections IV and V]

WorldCom generally supports the phased approach to granting the incumbent LECs greater pricing flexibility, with a few important qualifications. In general, it makes sense to offer the incumbent LECs certain pricing flexibility measures upon a showing of "potential competition" -- that is, when the incumbent LEC has done everything necessary to establish the possibility of local competition, including offering a combination of unbundled network elements at cost-based rates. At later stages in the process, when competition actually begins developing, broader pricing flexibility measures can be considered.

WorldCom supports two important modifications to the approach outlined in the Notice: (1) ensure that the initial threshold for pricing flexibility is high enough to give the incumbent LECs a serious incentive to fully implement all the measures necessary to stimulate competition; and (2) do not permit the incumbent LECs to implement measures that could unreasonably impede competition during the transition toward full competition. In addition, we outline a somewhat modified approach that the Commission could consider.

1. The Incumbent LECs Should Have to Meet a Rigorous Showing to Establish That the Triggering Conditions for Phase I – "Potential Competition" – Have Been Met.

WorldCom generally supports the triggering conditions outlined in the Notice as prerequisites for incumbent LECs to obtain the pricing flexibility measures associated with Phase I -- "potential competition." 80/ In particular, the Commission should take the opportunity presented by examining an incumbent LEC's petition for Phase I treatment to consider in detail the extent to which that LEC's offerings comply with the Commission's Local Competition Order. The Commission has jurisdiction to apply this standard regardless of how the U.S. Court of Appeals for the Eighth Circuit resolves the pending case. Indeed, the Commission has very broad authority pursuant to Sections 201-205 of the Act over the conditions governing the incumbent LECs' interstate access rates.

It is critical, in particular, that unbundled network elements be offered under pro-competitive terms and conditions and at forward-looking cost-based rate levels, in compliance with the Local Competition Order. To enable local carriers other than the incumbent LECs to compete fully, it is absolutely critical that they be able to purchase network elements from the incumbent LECs and to package

80/ Notice, ¶¶ 169-79.

together those elements in any manner they want 81/ -- where competitors like WorldCom have their own facilities and where they do not -- competitors must be able to make use of the ubiquity and scale efficiencies of the ILEC networks built during the period of government-sanctioned and enforced monopolies, at the same forward-looking costs that the ILECs in effect face in using those networks. 82/ The Commission should use the market-based approach to access reform to create an additional incentive for incumbent LECs to comply with these rules.

We observe that the conditions for Phase I pricing flexibility should be at least as high as the "competitive checklist" under Section 271 of the Act, 83/ and preferably somewhat higher. The Commission should not hesitate to examine de novo the reasonableness of the incumbents' rates, terms, and conditions for network elements and other interconnection offerings in the process of considering whether an incumbent LEC has satisfied the Phase I threshold. Moreover, while Section 271 contains a limiting provision that the Commission "may not limit or extend the terms used in the competitive checklist" 84/ -- and this provision is sure to be tested

81/ 47 U.S.C. § 251(c)(3); 47 C.F.R. § 51.307(c).

82/ See, e.g., Local Competition Order, ¶¶ 672, 679.

83/ 47 U.S.C. § 271(c)(2)(B). WorldCom will soon be filing comments on Ameritech Michigan's application pursuant to Section 271, to which we refer the Commission for a more detailed discussion of the Section 271 checklist.

84/ 47 U.S.C. § 271(d)(4).

in court, with the outcome of such a test far from clear -- no such limiting provision applies to the Commission's authority over access charge reform.

In addition, we believe that all pro-competitive state and federal rules and interconnection rights must be enforced vigorously and effectively as a precondition for Phase I relief, not just Phase II relief as the Commission proposes. 85/ In addition, competition would be distorted if non-competitively neutral universal service subsidies or residual access charges persist. Accordingly, the Commission should include full implementation of competitively neutral universal service support mechanisms and full elimination of the TIC or other residual charge as preconditions for Phase I relief. 86/

The Commission should impose one additional condition beyond those described in the Notice. Specifically, the Commission should require that incumbent LECs' non-recurring charges ("NRCs"), for both access services and local exchange services, are cost-based and non-discriminatory. The Commission adopted such a requirement in the context of expanded interconnection and competition for special access and switched transport, because it found that there was significant potential for incumbent LECs to use NRCs to discriminate against

85/ Notice, ¶ 207.

86/ Notice, ¶ 206.

competitors, and that incumbent LECs were in fact doing so. 87/ First, incumbent LECs can -- and have -- required customers to pay higher NRCs when reconfiguring to shift some service from the incumbent LEC to a competing carrier than they would pay for identical reconfigurations to take different services from the incumbent LEC. Such discrimination can make it quite costly for customers to shift service to a competing carrier, and effectively locks in customers to keep their service with the incumbent. Second, incumbent LECs can -- and have -- impose non-discriminatory, but quite high, non-cost-based NRCs for service reconfigurations. These, too, have the effect of unreasonably locking in customers' service with the incumbent.

While the Commission has had rules against such unreasonable discrimination in the application of NRCs in the context of special access and switched transport for several years, WorldCom believes it has never enforced those rules effectively. 88/ As an additional precondition for Phase I pricing flexibility,

87/ See Expanded Interconnection with Local Telephone Company Facilities, Transport Phase I, Second Report and Order and Third Notice of Proposed Rulemaking, 8 FCC Rcd 7374, 7439, ¶ 130 (1993), vacated on other grounds sub nom. Bell Atlantic v. FCC, No. 93-1743 (D.C.Cir. April 17, 1995); Expanded Interconnection with Local Telephone Company Facilities, Second Memorandum Opinion and Order on Reconsideration, 8 FCC Rcd 7341, 7361-63, ¶¶ 47-51 (1993) ("Expanded Interconnection Second Reconsideration Order").

88/ In establishing its rules governing expanded interconnection, the Commission noted that incumbent LECs could use NRCs to disadvantage competitors, and explicitly proscribed discrimination in the application of such charges: "We conclude that nonrecurring reconfiguration charges must be applied in a neutral manner that does not differentiate based on whether the customer

[Footnote continued]

the Commission should require incumbent LECs to show that their NRCs that may apply when customers terminate or reconfigure access or exchange services are cost-based and applied in a non-discriminatory manner.

2. During Phase I – "Potential Competition" – the Commission Should Not Permit Forms of Pricing Flexibility that Enable Incumbent LECs to Discriminate.

WorldCom recommends that some of the pricing flexibility measures proposed for Phase II, "substantial competition," be permitted, instead, during Phase I, "potential competition," and that other pricing flexibility measures proposed for Phase I be deferred to Phase II, at the very earliest. Specifically, WorldCom supports permitting most of the pricing flexibility measures that the Notice proposed for Phase I -- geographic deaveraging of carrier access services,

[Footnote continued]

chooses to use a CAP or LEC facilities for special access service unless there are specific, identifiable cost differences." Expanded Interconnection with Local Telephone Company Facilities, 7 FCC Rcd 7369, 7465 (1992) ("Special Access Expanded Interconnection Order"), vacated on other grounds sub nom., Bell Atlantic Tel. Cos. v. FCC, 24 F.3d 1441 (D.C. Cir. 1994); see also Expanded Interconnection with Local Telephone Company Facilities, 8 FCC Rcd 7374, 7438 (1993) ("Switched Transport Expanded Interconnection Order") ("[A]bsent even-handed treatment, nonrecurring reconfiguration charges could constitute a serious barrier to entry.") Notwithstanding these rules, incumbent LECs have applied NRCs in an unreasonably discriminatory manner to prevent large customers from switching LEC-provided services to services offered by interconnected competitive access providers ("CAPs"). See MFS Motion for Declaratory Ruling Proscribing Discriminatory Application of Local Exchange Carrier Nonrecurring Charges, CC Docket No. 91-141 (filed May 15, 1995) (documenting a number of specific examples of LEC violation or circumvention of the non-discrimination policy).

term discounts (though of no more than 3 years, and streamlined regulation of truly new services (those that cannot be substituted for existing access services) -- as well as certain measures proposed for Phase II -- geographic deaveraging of the SLC, and differential pricing of access services for calls that originate from or terminate to residential, single-line business, and multi-line business customers -- once an incumbent LEC has satisfied the Phase I conditions. And we support the Commission's tentative conclusion not to permit "growth discounts" at Phase I. 89/

We are very adamant, however, in our opposition to permitting incumbent LECs to engage in forms of pricing flexibility that could facilitate discrimination among access customers -- particularly contract tariffs, competitive response tariffs, volume discounts, and streamlined regulation of supposedly "new" services that actually can be substituted for existing access services -- during the transition from monopoly to competition. The "potential competition" conditions proposed for Phase I establish only one thing -- that competition has the potential to emerge. These conditions will not enable competition to take root, let alone grow, if incumbent LECs are permitted to snuff it out using discriminatory access pricing practices.

These pricing practices are particularly pernicious given that RBOCs are seeking to enter the long distance market, and other large LECs like GTE are

89/ Notice, ¶ 192.

expanding their activities in that market. Each of these practices can be used to provide unreasonable benefits to an incumbent LEC's long distance affiliate. 90/ And while such discrimination is prohibited by Sections 202, 254(k), and (in the case of an RBOC) 272(c)(1), if the Commission permits these pricing practices, it will seriously erode its ability to enforce these statutory prohibitions. 91/ Unreasonable discrimination in favor of favored (presumably, larger) unaffiliated access customers is hardly less problematic, and could distort the markets for long distance services as well as for local services.

Contract tariffs, for example, can be used to restrict the availability of a favorable service offering to specified access customers. Thus, while contract tariffs are theoretically open to all similarly situated customers, they were used, in practice, by AT&T to restrict a service offering only to customers with exactly the same volumes and geographic requirements as the targeted customer, and even to limit the offering to customers who sign up at the same time as the targeted customer. The practical result is to facilitate the offering of radically different

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90/ This is true if an incumbent LEC grants access discounts to its affiliates indirectly, such as through a mechanism where the LEC affiliate's end user customer is, as a formal matter, deemed to be the access customer of record.

91/ The requirement that services be offered to all takers at the same rates, terms, and conditions under standard tariffs, 47 U.S.C. § 203, is one of the most powerful ways to police against unlawful discrimination. Contract tariffs, volume discounts, and other similar practices discussed below represent a major step away from this principle, even if the form of tariff filing is retained.

service packages to different customers. AT&T's Tariff 12 options, at least, were introduced many years after the effectiveness of many conditions comparable to the "potential competition" prerequisites at issue in this proceeding.

By contrast, such offerings have a much greater potential for anti-competitive mischief in this context. The incumbent LECs' access offerings are an "intermediate" service in inter-related local exchange, long distance, and interexchange access service markets, in at least two of which the incumbents will continue to exercise substantial market power for the foreseeable future. Unlike the long distance services in AT&T's Tariff 12, the access services at issue here can be used by the incumbent LECs to leverage their local monopoly power into long distance markets, and to discriminate against prospective full-service competitors in local as well as long distance markets.

Competitive response tariffs are even more restrictive and potentially anti-competitive than contract tariffs. They are restricted only to customers that have issued a Request for Proposals and have received offers from competing providers; similarly situated customers cannot necessarily take advantage of the same offerings. When incumbent LECs face incipient competition for particular access services purchased by particular customers, they should not be permitted to forestall such competition by offering favorable rates to particular customers that can be addressed by competitors, while retaining their unreasonably high rates for their remaining customers. Rather, such competitive developments should stimulate the incumbent LECs to reduce their rates for all customers. Permitting competitive response tariffs would have the opposite of the intended effect -- to use market pressure to induce more cost-based access charges. Instead, incumbent LECs would use such tariffs to avoid lowering their generally available access rates, while preventing competitors from gaining a foothold.

Volume discounts are hardly less problematic. Like contract tariffs and competitive response tariffs (and unlike term discounts, with which volume discounts are frequently, but fallaciously, coupled), volume discounts can be used by incumbent LECs to confer non-cost based advantages to larger access customers. Particularly given the incumbent LECs' stated intentions to enter in-region long distance markets, volume discounts would facilitate self-dealing. Moreover, even when offered to non-affiliated access customers, volume discounts can be used to lock in access customers (potentially including end users that also purchase local exchange services) who might otherwise consider dividing their traffic volumes between the incumbent LEC and a new local competitor.

Moreover, to the extent the Commission permits volume discounts, it should, at the very least, impose the condition on such discounts that it has imposed in the past -- that such discounts be proven cost-justified. 92/ That is, the incumbent LEC must show that the discounted rate is not below cost and not predatory. As an additional measure of safety, if the Commission decides to permit

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92/ See Expanded Interconnection with Local Telephone Company Facilities, Memorandum Opinion and Order, 9 FCC Rcd 5154, ¶¶ 168-71.

volume discounts, it must require incumbent LECs to demonstrate that the magnitude of the discount is cost-based: that is, that the reduction in the rate for the volume commitment is commensurate with the reduction in cost that the incumbent LEC incurs to provide the higher volume of service. Such a cost showing would mitigate the concerns about using volume discounts to confer unreasonably discriminatory advantages on access customers that make larger volume commitments to incumbent LECs.

Similarly, while term discounts are a common feature of competitive segments of the telecommunications industry, very long term plans with large cancellation penalties can be a major disincentive for customers to switch from incumbents' offerings to new carriers. Accordingly, we recommend that, during Phase I, incumbent LECs be permitted to offer term discounts with terms no longer than 3 years, and with cancellation penalties no greater than those that the Commission has prescribed in connection with local competition developments in the past. 93/

Finally, while it may seem appealing to "deregulate new services" when the Phase I triggering conditions are met, the Commission should take care to

93/ See Expanded Interconnection with Local Telephone Company Facilities, CC Docket No. 91-141, Report and Order and Notice of Proposed Rulemaking, 7 FCC Rcd 7369, ¶¶ 201-202 (1992), recon., 8 FCC Rcd 127 (1992), vacated in part and remanded sub nom. Bell Atlantic v. FCC, No. 92-1619 (D.C. Cir. , June 10, 1994); recon., 8 FCC Rcd 7341 (1993).

define what is considered a "new service" narrowly to avoid potentially unreasonable discrimination. Currently, the price cap "new service test" applies not only to truly new services, but also to revised versions of existing services, as long as no previously existing rate elements are withdrawn when such services are introduced. This contorted definition of "new" services may have made some sense within the narrow context of the price cap system, but it would be catastrophic to apply it beyond that context, particularly when considering deregulating (or streamlining regulation of) such services.

The existing price cap definition of "new" services would deem as "new" a service that is virtually identical to an existing service, except that it is designed with some special feature that is only usable by one customer (or a narrow group of customers). That customer could well be a long distance affiliate of the incumbent LEC. The deregulation of "new" services proposed for Phase I would eliminate the Commission's ability, through the tariff review or complaint process, to police the use of such services to discriminate unreasonably in favor of their affiliates or other favored customers.

WorldCom supports streamlined regulation of truly new services when the Phase I conditions are met. For example, if the incumbent LEC designs a different interstate offering that (a) has never been offered before, (b) provides significantly different functionality than existing offerings, and (c) is not a bottleneck service that competing carriers must use to offer services themselves, then the LEC should be able to offer that service subject to minimal regulation once the Phase I conditions are met. But the Commission must define which services are "new" carefully to avoid the possible abuses described above. We suggest using the economic concept of cross-elasticity of demand as the basis for such a definition: if there is significant cross-elasticity of demand between the allegedly "new" service and an existing service, then the two services are close substitutes and the "new" service should not be exempt from regulation. On the other hand, if the cross-elasticity of demand between the new service and existing services is minimal, then streamlined regulation may be appropriate.

3. The Commission Should Apply a Rigorous Economic Test to Determine When "Substantial Competition" Exists.

In the Notice, the Commission seeks comment on how it should define competitive presence for purposes of granting incumbent LECs broader pricing flexibility under Phase II, "substantial competition." WorldCom suggests two factors for the Commission's consideration. First, an incumbent LEC desiring Phase II pricing flexibility measures should be required to show that the same competitive preconditions exist in the applicable geographic area as existed when the Commission adopted streamlined regulation for AT&T in 1991.

Second, the Commission should use the most accepted measurement of competitive presence used in antitrust law and economics -- the Herfindahl-Hirshman Index ("HHI"), which measures the degree of market concentration in an industry. 94/ Specifically, an incumbent LEC should be required to show that the HHI for the applicable local telecommunications service market or markets is at least as low as the HHI for the AT&T long distance services to which the Commission applied streamlined regulation in 1991. 95/ This approach would measure a static "snapshot" of actual competitive entry in the best manner currently known to industrial economics theory. 96/

In addition to these measures, of course, the Commission should require incumbent LECs to verify that all the preconditions for Phase I relief are still satisfied before Phase II relief will be granted.

Finally, the Commission should reconsider some of the pricing flexibility measures proposed for Phase II. While incumbent LECs should be facing a substantial degree of competition during Phase II, they will still hold a dominant position in local markets. Moreover, as discussed above, certain access charge elements, most notably charges for terminating access, will never be subject to

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94/ Horizontal Merger Guidelines, 57 Fed. Reg. 41552 (1992).

95/ Competition in the Interstate Interexchange Marketplace, CC Docket No. 90-132, Report and Order, 6 FCC Rcd 5880 (1991), recon., 6 FCC Rcd 7569 (1991), further recon., 7 FCC Rcd 2677 (1992), further recon., 8 FCC Rcd 2659 (1993), petition for review sub nom. AT&T v. FCC dismissed as moot, No. 93-1306 (D.C. Cir. 1994).

96/ For example, in the case of originating access, the relevant service market is local telephone service. Measurable competition in local exchange telephone service markets would provide relevant data regarding whether originating access is being avoided.

effective competition. The Commission should not deregulate the rate structure rules for transport and local switching for dominant LECs, particularly not for terminating access charges.

4. The Commission Should Consider A More Finely Textured Approach.

One drawback of the approach described in the Notice is that it includes only two phases. In reality, the transition toward competition is likely to take a significant amount of time, and several intermediate stages may be identified during that transition period. For example, Phase II could be subdivided into two intermediate phases: Phase II-A, "emerging full-service competition", and Phase II-B, "substantial full-service competition." The showing for Phase I would be the measures proposed in the Notice, as well as credible and timely enforcement of those measures, plus full elimination of the TIC (or comparable charges) and full implementation of competitively neutral universal service mechanisms. The showing for Phase II-A could be somewhat higher, including a competitive presence test, such as some type of showing of the availability of local telephone service from facilities-based competitors to a certain minimum percentage of both residential and business customers throughout the targeted geographic area. As discussed above, Phase II-B would involve a more substantial competitive presence showing, such as a measure of the competitiveness of local markets using the HHI.

Under this approach, the pricing flexibility measures could be spread out over the three phases -- Phases I ("potential competition"), II-A ("emerging full-service competition"), and II-B ("substantial full-service competition"). A possible way to spread out these measures is illustrated in Table 2.

C. The "Stick": Prescriptive Access Rate Reductions.

[Notice, Section VI]

WorldCom would very much like to see access rates based on forward-looking costs, but we recognize the practical difficulties of making prescriptive rate changes in the very near term, particularly if the Commission seeks to adopt an order in this proceeding this spring. We are willing to test the use of a market-based approach -- even though in the short run it leaves our stand-alone long distance operations very exposed -- because in the long run we believe that competitive forces, if allowed to work, may be even more effective in producing cost-based access rates than prescriptive approaches. If the Commission makes the rate structure reforms and the initial prescriptive rate level changes that WorldCom recommends, and if the incumbent LECs comply fully with the requirements of Sections 251 and 252, as interpreted by the Commission, 97/ then market pressures should be effective in inducing the incumbent LECs to bring access most rates toward cost.

In our view, however, the most vulnerable piece of this puzzle is the implementation of the prerequisites to competition, particularly cost-based

97/ See Local Competition Order.

unbundled network element offerings. If any incumbent LEC, through litigation, undue political influence at the state level, or other measures, successfully resists implementation of the unbundled network element requirements, and such measures have not been implemented by January 1, 1999, then the Commission should be prepared to prescribe access charges based on a measure of forward-looking economic costs such as TSLRIC or TELRIC. If necessary to induce rapid rate reductions, the Commission could prescribe rates based on proxies, with the burden on the incumbent LEC to show (in the course of a tariff investigation proceeding) that higher rates may be justified.

Regardless of the outcome of the Eighth Circuit litigation, the Commission has authority to establish the conditions surrounding the levels of access charges, and to prescribe just, reasonable, and not unreasonably discriminatory rates pursuant to Sections 201-205 of the Act. Because of the inseparable relationship between local exchange competition and the provision of access services, the Commission can reasonably conclude that, in the absence of the necessary preconditions for effective local competition, a strictly prescriptive approach is necessary. And there should be absolutely no question, in such a case, of the incumbent LEC recovering any residual amounts or alleged embedded costs. 98/

98/ Even if an incumbent LEC could make a case for an entitlement to some amount of such costs, the Commission could reasonably impose a very severe

[Footnote continued]

As discussed above, we believe that certain prescriptive rate level changes are necessary for all incumbent LECs in the baseline scenario, regardless of how competition develops. In addition, we continue to support the modifications to the existing price cap system under consideration based on the Fourth Further Notice of Proposed Rulemaking in the LEC Price Cap Performance Review proceeding. 99/ For example, the Commission should consider increasing the productivity factor used in the price cap system, also referred to as the "X-factor," to better reflect actual and forecast industry productivity changes, and should consider an increase in the consumer productivity dividend. Finally, in response to the Notice's request for comments on the treatment of any other remaining embedded costs allocated to the interstate jurisdiction, we refer to our discussion of the TIC above. 100/ The same analysis we present concerning the TIC apply with even more force to any other mechanism proposed to recover other residual costs.

[Footnote continued]

penalty on such a LEC for failure to comply with the requirements of Sections 251 and 252 of the Act, and deprive it of such cost recovery.

99/ See Price Cap Performance Review for Local Exchange Carriers, Fourth Further Notice of Proposed Rulemaking, CC Docket No. 94-1, 10 FCC Rcd 13659 (1995); see also Reply Comments of LDDS WorldCom, Price Cap Performance Review for Local Exchange Carriers, CC Docket No. 94-1 (filed Mar. 1, 1996).

100/ Notice, ¶¶ 260-70; see supra Section II-E.